

Jeremy Siegel on the Upside for Equities and the Virtues of QE2

By Robert Huebscher
November 16, 2010

Jeremy Siegel is the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania and a Senior Investment Strategy Advisor to Wisdom Tree Funds. His book, Stocks for the Long Run, now in its fourth edition, is widely recognized as one of the best books on investing. It is available via the link below. He is a regular columnist for Yahoo Finance and is frequently quoted in the financial press.

I spoke with Professor Siegel on November 9.

When we spoke [last year](#), it was December 23rd and the S&P was at 1,118. It's now at 1,223. So it's about 9.3% higher, and that's within your band of prediction. It's at the low end, but you were one of the few people at the time who was forecasting a bull market of any kind. What is your outlook now?



Well, it's interesting. I actually looked back at last year's interview, and I said, "Wow, I was pretty right on the stock market, but I was wrong on the interest rate." I thought the Fed would start raising interest rates.

One of the most remarkable developments over the past year is that the economy has been weaker than I and most people expected, to say the least. I don't think there's a double-dip at all now, and I was not in that camp. But certainly I expected there to be a more robust recovery. Yet, despite that, earnings are higher than what I predicted and what almost all analysts predicted a year ago.

Think about this. The economy is much weaker, but earnings are higher. You can ask, "Well, how can that happen?" It happened in two ways. First of all, it was because of strong global growth and the fact that so much of corporate profit, particularly for the S&P 500, comes from global sales. It was also because of remarkable cost-cutting and efficiency gains that were made by corporations.



What are the two things we know are the most important ingredients in determining stock price? It is earnings and interest rates. Earnings are higher than expected. Interest rates are lower than expected. So, when I look at the fair market value now of the market, I see it appreciably higher than our current levels, and I can easily see the market growing 10-20% over 2011. And, by the way, I even see a nice gain through the end of 2010.



Do you feel that we've come to an end of the expansion of corporate profit margins, or is there still room for them to grow?

Margins are great. Certainly, we've done most of the cost cutting, and now we need the sales to increase. The leverage is huge. If firms can make profits with sales being as sluggish as they've been this year, think how much profit they'll make if sales start going up. I'm one of those people who, whenever they announce the earnings and others say, "Oh my God, yeah, they topped their estimate on earnings, but they didn't make their revenue," I say, "Hey listen, that's not bad." I'd much rather they top on earnings and miss on revenue than fall short in earnings and make more revenue. If revenue is above what they expected and they can't make their earnings, that's not a good sign.

So, corporate America is levered up in such a way that when we do get that boost in spending, which I think will come in 2011, we will definitely get more profits.

What is your forecast now for interest rates, and how does that influence your assessment of the fair value for U.S. equities?

Last year I thought they were going to rise this year, but now I have more confidence now that interest rates are going to rise in 2011, because I believe we are going to have a stronger economy. We are going to have some more inflation. Those things that I expected for 2010 are delayed a year, but they're going to happen. Both of those factors will raise interest rates to the on the long end to 4% or 5%. The 10-year bond could easily go to twice its yield, which right now is 2.5%, over the next year.

Let me give you some earnings estimates, because I did that last year and that's the most useful way to go. I just looked it up for our interview. The 2011 estimate for operating earnings on the S&P 500 is \$94.27. Now, that translates to a 15 P/E ratio – and, by the way, that's a very conservative P/E, given the level of interest rates. In fact, it's even a conservative P/E given 5% interest rates. That P/E ratio should translate to over 1,400 on the S&P. That's already going to provide a 15-20% return.

If you look through history, you see that whenever interest rates are below 6-7%, the average P/E, believe it or not, has been 19 over the last 50 years. Now, of course that gives you blow-out levels for the S&P at 1,700, and I'm not saying that is going to be realized in one year. But it would not be out of the question in terms of the fair market valuation.

Right now, on the basis of 2011 earnings, we have a 12.5 P/E ratio. That is low on an absolute scale and extremely low given these interest rates.



Just to be clear, you're using operating earnings and not as-reported earnings.

I'm using operating earnings. As I said last year – and it's held true – as-reported earnings are about 10% lower than operating earnings. The two are hugging each other very tightly. I suggested last year that some of the financial firms might actually do write-ups. Well, they stopped their bleeding on write downs. There have been a few isolated write-ups. There might be some write-ups in 2011 for some of the extraordinarily depressed assets, but I don't think as-reported earnings are going to come out that much lower. If you want, you could use as-reported earnings, which I have written and believe are too conservative for evaluation. I think GAAP earnings are maybe as they should be; they err on the conservative side. The truth is somewhere between operating and as-reported earnings – probably a little bit closer to operating, but nonetheless we're not talking about big differences here. These low valuations are still there.

How does the flow of funds enter into your thinking about valuation? There's been a lot of money, retail money in particular, that has flowed into bond funds. Can equities still rally even if those flows continue?

Of course. This is the climate that can sustain a rally in equities. When everyone's out of something, that's when that asset class can rally. People are going to be very disenchanted with bonds. As interest rates go up, they are going to look and say, "Whoa, this is not where I want to be." I'd rather be in dividend-paying stocks. Actually, for the conservative investor, dividend-paying stocks are going to be the play of 2011.

The dividend yield on high-quality stocks now is about twice the yield on bonds.

The dividend yield on the S&P is about 2%. But if you take the dividend-paying stocks, specifically those that are very well covered, such as the blue-chips, you are getting 4% and 4.5% and even 5% in some cases. That's even more true on an international basis.

I want to switch subjects a little bit and talk about quantitative easing – QE2. I know that you're on record as supporting it, and I'd like to run through some of the possible motivations for that policy and to better understand the rationale behind it. One of the reasons you've given for the Fed's decision is to increase the flow of credit. Yet I read yesterday that the Fed senior loan officer survey showed that there was still weak demand from large- and medium-sized firms. I'm wondering, is the problem with credit a lack of demand or a lack of supply?

It's a little bit of both. Honestly, obviously in a weak economy you're going to have a lack of demand. But for small companies, and even medium and large companies, we know the credit risks. Talk to people who are trying to get mortgages. The documentation is much harder than it used to be. These are small loans a lot of people could secure with their homes, and it's tough to get now. If we get more reserves out there it will help, since the cost of these reserves is low – banks only earn 25 basis points on reserves. Banks



can do much better in the loan market if you give them a little push in that direction, and I think QE2 will do that. It will make the banks more likely to move into that area.

By the way, three and a half trillion dollars' worth of money is in money market funds earning zero now. Think about how that can move into the market.

With all this money in money market funds, the Fed is basically creating more bank reserves, which mean more bank deposits that are going to earn nothing. People are going to now say, "I want to move into stocks." It may raise real estate prices a bit too, and lending on real estate and the demand for real estate will increase. [QE2] is supposed to reflate some of these assets, which is going to be a big positive.

There's a lot of talk about fears that the Fed could be creating bubbles in markets.

Where, in gold? Come on. A bubble in gold? These are not things that are wrecking the economy. What other bubbles are there? They talk about a bubble in real estate. These people are just talking. They don't have any basis for what they're saying.

Related to the housing market, banks are under pressure again because of problems with foreclosure paperwork. Do you think that part of the motivation behind the Fed's actions is to ensure the continued stability of the banking system? And are they worried about another round of systemic problems?

I don't think they're worried about it, but they just think that everything will be better if we just have some money flowing into real assets, such as stocks and real estate. You pump up those prices a little bit and that will ease some of these burdens. They've been terribly depressed. If we get a 10% run in stocks or real estate from here, or we're able to just stabilize the real estate, that's better than letting it fall some more.

It's not wrong to hope this policy will be effective. It's going to make everyone feel better off. Half of Americans own stock. If that goes up, and they see their 401(k)s go up, that's going to make them feel better. Homeowners will begin to say, "Gee, things are beginning to sell. I feel a little bit better about that." This is all very critical to the psychology of getting the recovery on track.

The primary motivation, as you mentioned earlier, is to avoid deflation. Although inflation is still very modest, we are seeing rises in commodity prices. How successful ultimately do you think it will be in inducing higher inflation? And is that really the Fed's primary goal?

They want to stop deflation. They are aiming towards 2-3%, and they think that in real asset prices that might be even a little higher, because there's a little leverage in those assets. That's their goal – to nudge it up a little bit. Nothing excessive, and they definitely have the tools to ease it on the other side.



I'm a very strong supporter of this. This is absolutely the right policy to pursue at this point.

Let's talk about the so-called tail risks, and the possibility of unlikely but not impossible events. For equity investors, what do you perceive is a greater threat: a Japan-like lost decade or a bout of very high inflation? How should investors think about protecting against those risks?

When you talk about a decade-long risk, that's not something that's an immediate concern. It's going to take a decade for us to know about that. The Fed definitely wants to avoid that, and they want to avoid rapid inflation. The Fed has the tools to avoid both. Right now, pumping up asset values a bit and keeping inflation at the 2-3% mark is the right policy. At this point, I'd rather err on the side of slightly higher inflation than potential deflation.

Thank you. You've been more accurate than virtually anyone else to whom I've spoken and asked similar questions.

I'll admit all of the mistakes I made, including not seeing this crisis coming or the effect of the leverage that the banks held, but I believe I was one of the few people who stayed positive on stocks when everyone else was so negative.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>